No. 10551

In the United States Circuit Court of Appeals for the Ninth Circuit

J. B. CLOVER, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 21–34) is unreported.

JURISDICTION

This petition for review (R. 36–38) involves federal income tax for the year 1935. On March 14, 1939, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiencies for the years 1934 and 1935, in the total amount of $13,675.60 plus a penalty of $6,565.12 for the year 1935. (R. 7–12.) Within ninety days thereafter the taxpayer filed a petition with the Board of Tax Appeals [1] for a redetermination of those deficiencies under the provisions of Sec-

[1] Now the Tax Court of the United States.

tion 272 of the Internal Revenue Code. (R. 2–6.) The decision of the Tax Court sustaining the deficiencies was entered February 18, 1943, and deficiencies determined in the amounts of $406.40 for 1934 and $8,382.85 for 1935. (R. 35.) (The claim for the penalty of $6,565.12 for the year 1935 was expressly withdrawn at the opening of the trial. (R. 28.)) Petition for review of the Tax Court's decision as to the year 1935 was filed May 8, 1943 (R. 36–38), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

The taxpayer received a condemnation award of $20,000 from the City of Los Angeles for his littoral rights. This was admittedly capital gain from an involuntary sale of property. Taxpayer also received $41,000 from Nev-Cal Securities Company "as consideration for the dismissal of appeal and waiver of right to appeal" from the judgment entered. Is the $41,000 also capital gain from the involuntary sale of taxpayer's littoral rights within the meaning of Section 117 of the Revenue Act of 1934, as contended by the taxpayer, or is it ordinary income realized from "forbearance to exercise a legal right," as contended by the Commissioner?

STATUTES INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from

salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *General Rule.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

100 per centum if the capital asset has been held for not more than 1 year;

80 per centum if the capital asset has been held for more than 1 year but not for more than 2 years;

60 per centum if the capital asset has been held for more than 2 years but not for more than 5 years;

40 per centum if the capital asset has been held for more than 5 years but not for more than 10 years;

30 per centum if the capital asset has been held for more than 10 years.

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or

not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

STATEMENT

This appeal involves an income tax deficiency for the year 1935 only. The facts pertinent to the taxpayer's receipt of $61,000 in that year may be summarized as follows (R. 21–39):

Taxpayer, a construction engineer, is a resident of Los Angeles, California, and filed his income tax return in the Sixth District of California. (R. 21.)

In 1918 the taxpayer acquired 480 acres of land in Mono Basin, California, which had riparian rights on Rush Creek and littoral rights on Mono Lake. The value of the littoral rights was nil. (R. 22.)

Prior to 1930 the City of Los Angeles entered upon a large project for the use of the waters of Mono Basin. Water rights were in some instances acquired by contract and in others by condemnation. In 1933 the city contracted to purchase from Nev-Cal Securities Company and other corporations their land holdings and water rights in the Basin. The contract provided *inter alia* that $2,230,000 of the purchase price be paid in escrow and held until awards for condemned properties should be fixed. It provided

further that $100,000 of such awards be borne by the city and any excess by the sellers. (R. 23.)

On June 23, 1934, a judgment condemning the water rights of the taxpayer and others was entered in the city's favor. The taxpayer was awarded $68,000 [2] as compensation for his riparian rights in the 480 acres and $20,000 as compensation for his littoral rights. (R. 23.)

On November 21, 1934, the taxpayer filed notice of appeal from that part of the judgment awarding him $20,000 for the littoral rights. On May 28, 1935, and while the appeal was pending, the taxpayer sold and assigned all his right, title and interest in the $20,000 award to Nev-Cal Securities Company, stipulating and agreeing that the assignee might prosecute any appeal or other proceeding in its own name. The taxpayer made this assignment (R. 24)—

> for and in consideration of the payment into court of the sum of Twenty Thousand Dollars ($20,000.00) in satisfaction of judgment and the sum of Two Hundred Seventy-seven and 50/100 Dollars ($277.50) costs * * *, and in consideration of the payment to [him] of an additional sum of Twelve Thousand Dollars ($12,000.00) by the Department of Water and Power of the City of Los Angeles.

On his 1935 joint return taxpayer reported as income an item of $55,000 called "damage to property by severance of water rights." He also took a deduction of $55,000 for an item entitled the same. (R. 27.)

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[2] The taxpayer accepted payment of the award of $68,000 as compensation for his riparian rights, $62,375 being received in 1934 and the remaining $5,625 being received in 1935. (R. 23–24.)

In his notice, showing a deficiency of $13,130.24, the Commissioner asserted the correct income from this source as follows (R. 11):

Cash received from the Southern Sierras Power Company for the assignment of interest in a condemnation award against the City of Los Angeles, California	[1] $66,625.00
Less:	
Attorney's fees paid during 1935 in connection with the assignment of the award	5,625.00
Capital net gain, 100% subject to tax	61,000.00

[1] This figure is comprised of the $5,625 received for the riparian rights in 1935; the $20,000 award for the littoral rights which taxpayer assigned; and the $41,000 received as consideration for dismissal of the appeal.

Although having designated the entire $61,000 as capital gain in the deficiency letter, upon trial before the Tax Court and in his brief the Commissioner contended that $41,000 of this amount was ordinary income and not subject to the 30 percent capital gain rate. (R. 31.)

The Tax Court sustained the Commissioner's contention and held (R. 31) that the $20,000 received for taxpayer's assignment of his interest in the judgment award for littoral rights constituted proceeds from the disposition of a capital asset held over ten years and was therefore taxable only to the extent of 30 percent. It also held (R. 32) that the $41,000 was received in consideration for the taxpayer's dismissal of the appeal of the littoral award and was ordinary income.

SUMMARY OF ARGUMENT

By virtue of a judgment condemning his littoral rights the taxpayer was awarded $20,000. When the judgment was entered a legal right to contest the

amount of the award vested in the taxpayer. Instead of exercising his right and possibly obtaining an increase in the award, the taxpayer chose to accept an offer of $41,000 in return for dismissing his appeal from the award made. This offer was not in settlement of the award for it was made by an outsider not a party to the condemnation proceedings. By dismissing his appeal the taxpayer thereby accepted the award of $20,000 and was paid that amount. This award of $20,000 is recognized to be a gain from the sale of a capital asset. However, the waiver of his legal right and dismissal of the appeal was not the sale of a capital asset. No property was conveyed to anyone. The $41,000 which taxpayer received for his forbearance to contest the award was ordinary income and not a capital gain.

ARGUMENT

In consideration for his forbearance to appeal a judgment award the taxpayer received ordinary income in the amount of $41,000 taxable under Section 22 (a) of the Revenue Act of 1934

The Tax Court found (R. 24) that the taxpayer sold and assigned all his right, title, and interest in the $20,000 award for littoral rights to Nev-Cal Securities Company "for and in consideration of the sum of Twenty Thousand Dollars ($20,000.00) to him in hand paid, by Nev-Cal," and that the taxpayer also received $41,000 from Nev-Cal "as consideration for the dismissal of appeal and waiver of right to appeal" by the taxpayer.

The Tax Court further held that the two were separate and that their different characters were not to be ignored for tax purposes. (R. 32.)

The taxpayer attacks the decision on the grounds that the above sums were received in one transaction and that the $41,000, as well as the $20,000, received from Nev-Cal was from the sale of his water rights. We submit that there were two transactions involved and that the above mentioned sums were received for two entirely different things.

In 1935 the taxpayer owned an award of $20,000 for his water rights. Nev-Cal had an agreement (R. 23) with the City of Los Angeles under which it was to pay all "awards" in excess of $100,000.[3] Nev-Cal paid the taxpayer's award according to its agreement. This admittedly amounted to a sale of a capital asset. *Hawaiian Gas Products* v. *Commissioner,* 126 F. 2d 4 (C. C. A. 9th). Since the taxpayer had held his water rights for more than ten years only 30 per cent of the gain received is to be taken into account in computing his net income. Section 117 (a) of the Revenue Act of 1934, *supra.* Therefore, the only question involved is whether the $41,000 received by taxpayer was also in payment for his water rights as contended by the taxpayer or was in payment for the taxpayer's dismissal of his appeal and taxable as ordinary income under Section 22 (a) of the Revenue Act of 1934, *supra,* as contended by the Commissioner.

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[3] Presumably, although the record does not disclose the fact, the awards made were in excess of $100,000 at the time the taxpayer received his judgment.

The taxpayer's assertion (Br. 9) that the Tax Court disregarded substance for form is not borne out by the facts. On the contrary the Tax Court found that the forms employed by the taxpayer, under which he received two separate payments, accurately presented the real and factual substance of the transactions. The record upon the hearing was voluminous. Apparently the taxpayer did not deem it necessary or expedient that the record upon this appeal contain either of the instruments from which the Tax Court made the above findings. It is well established that if the evidence in the record before this Court is not shown to be complete as to the issue before the Court, there is no basis for determining that a finding of fact by the lower court was not supported by substantial evidence and the finding must be accepted. *Helvering* v. *Ward,* 79 F. 2d 381, 383 (C. C. A. 8th), and cases cited therein.

The taxpayer seems to suggest (Br. 11) that the Tax Court's inquiry into Nev-Cal's reason for payment of the $41,000 (R. 32) was an attempt to change his own tax status. There is no foundation for this suggestion. Since the parties to that transaction were the taxpayer and Nev-Cal, it was certainly permissible for the Tax Court to inquire into Nev-Cal's conception of what it was purchasing in determining the true character and substance of the transactions.

Obviously, there are many cases holding that two separate contracts do not convert what is in reality one transaction into two separate and distinct transactions, or that one contract may embody two separate

transactions. *Helvering* v. *Ward, supra.* Here two forms were employed and it was found that they accurately represented two separate transactions. The taxpayer chose to accept the $20,000 award and to sell his right to litigate for an increase of that amount. It is only natural to suppose that he may have considered his chances upon appeal to be of less value than the offer made him by Nev-Cal. But whatever his reasons may have been, he disposed of his legal right without exercising it. The fact that a third party induced him to do so by a payment of money has no effect upon the award actually given him for his water rights. As stated by the Tax Court (R. 32): " 'The choice of disregarding a deliberately chosen arrangement' is not available to the taxpayer" (citing *Gray* v. *Powell,* 314 U. S. 402).

Even if it could be said that there was but one transaction involved, the fact remains that the taxpayer sold two entirely different things. One he sold to the city and the other he sold to Nev-Cal. The taxpayer asserts (Br. 11) that Nev-Cal was in privity with the city and that the payment of $41,000 by the latter was the same as payment by the city. The facts are to the contrary. Nev-Cal was in privity with the city only as to an agreed portion of amounts awarded for water rights. There is certainly no evidence that Nev-Cal was under any obligation to the city to pay more than an actual fixed award. The private arrangement between the taxpayer and Nev-Cal, whereby Nev-Cal offered the taxpayer $41,000 in consideration for the dismissal

of his appeal, is on an entirely different footing. Nev-Cal was merely bargaining for the cessation of the taxpayer's litigation for the reason that it was compelled to await disposition of that litigation before it could obtain payment of $2,230,000 for its own land holdings and water rights. (R. 23.) In this it was not in privity with the city.

Nev-Cal was not a party to the condemnation proceedings. It did not acquire the taxpayer's water rights. Under no theory can it be said that the condemnation proceedings constituted a sale to Nev-Cal. Regardless of whether Nev-Cal was motivated solely by a desire for a speedy settlement of the condemnation award, or by a fear that the award might be increased or by a combination of both motives, the fact remains that Nev-Cal purchased the taxpayer's forbearance to exercise a legal right. That legal right was no part of the award for taxpayer's water rights. Forbearance to exercise this right is analogous to forbearance to compete in a trade or business. In *Beals' Estate* v. *Commissioner,* 82 F. 2d 268, 270 (C. C. A. 2d), it is said:

> A promise not to work for others or for oneself is no more a conveyance of property than is a promise to enter the promisee's employ. Payment for either promise is income, not proceeds received on disposal of a capital asset.

See also *Ehrlich* v. *Higgins* (S. D. N. Y.), decided September 27, 1943 (1943 C. C. H., par. 9608); *Salvage* v. *Commissioner,* 76 F. 2d 112, 113, affirmed, 297 U. S. 106.

The taxpayer refers (Br. 8) to cases wherein it has been held that "interest" included in condemnation awards on account of lapse of time is also to be treated as capital gain. The Supreme Court held in *Kieselbach* v. *Commissioner,* 317 U. S. 399, that those decisions were in error. The Supreme Court said (p. 403):

> It [interest] is income under § 22, paid to the taxpayers in lieu of what they might have earned on the sum found to be the value of the property on the day the property was taken. It is not a capital gain upon an asset sold under § 117.

It seems to us there was more substance in the contention that interest paid on an award should be treated the same as the award itself than in the contention made by this taxpayer.

The taxpayer also seems to contend (Br. 13–14) that his right to appeal was a capital asset which had been held for more than ten years. Even if we accept *arguendo* his contention that it was a capital asset, it did not come into existence until June 23, 1934, when the judgment condemning the water rights was entered. (R. 23.) Taxpayer dismissed his appeal on May 28, 1935. So it is clear that his right to appeal was held less than one year and if it were a capital asset 100 per cent of the $41,000 received should be taken into account under Section 117 (a), *supra.*

CONCLUSION

We submit that the decision of the Tax Court correctly held that the taxpayer received an ordinary gain of $41,000 which is taxable in full under Section 22 (a) of the Revenue Act of 1934.

Respectfully submitted.

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JANUARY, 1944.

U. S. GOVERNMENT PRINTING OFFICE: 1944